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No. 94, Original

Supreme Court, U.S.

FILED

MAY 9 1987

IN THE
SUPREME COURT OF THE UNITED STATES, JR.
OCTOBER TERM, 1984 CLERK

STATE OF SOUTH CAROLINA,
Plaintiff

NATIONAL GOVERNORS' ASSOCIATION,
Plaintiff In Intervention,

v.

JAMES A. BAKER, III,
SECRETARY OF THE TREASURY OF THE
UNITED STATES OF AMERICA,
Defendant

BRIEF OF THE AMICUS CURIAE STATES OF
PENNSYLVANIA, ALASKA, ARIZONA, FLORIDA,
HAWAII, INDIANA, IOWA, LOUISIANA,
MARYLAND, MISSISSIPPI, MISSOURI,
MONTANA, NEW HAMPSHIRE, NEW JERSEY,
NORTH CAROLINA, NORTH DAKOTA, OHIO,
OKLAHOMA, VERMONT, VIRGINIA, WEST
VIRGINIA, WISCONSIN, AND WYOMING
IN SUPPORT OF PLAINTIFF

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INTEREST OF AMICI CURIAE

The interest of the amici states in this case is the imperative need to administer their own fiscal affairs free of interference from the national government. As sovereign entities within the federal system, the states have historically had the right, and the responsibility, to provide essential public services, to raise the revenues necessary to fund them, and to decide how these revenues will be raised. In order to continue to do this in an effective and efficient manner, the states must retain the ability to raise funds through, among other means, debt instruments which are competitive in the marketplace and which are not unreasonably burdensome or costly to administer.

"The power to make decisions and set policy is what gives the state its sovereign nature." FERC v. Mississippi, 456 U.S. 742, 761 (1982). This sovereignty is inherent in the federal system of government established by the Constitution.

Section 310(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), now codified as §103(j) of the Internal Revenue Code, directly impairs this sovereignty. The requirement that municipal bonds must be registered or have their interest taxed is not merely an abstract encroachment on state sovereignty. This legislation has the very real, practical effect of eliminating one of the options historically available to states for raising revenue.

Simply put, the inability of the states to issue tax-exempt bearer instruments increases the cost, and hence the difficulty, of securing revenue and providing public services. The legislation thus impairs the ability of the states to make decisions and set policy.

Amici states submit that this legislation is an unconstitutional exercise of Congress' taxing power in that it impermissibly infringes on state sovereignty, while at the same time creating no substantial benefit for the federal government. Amici have a clear stake in the outcome of this case, and respectfully urge this Court to find §310(b)(1) of TEFRA unconstitutional.

SUMMARY OF ARGUMENT

The doctrine of intergovernmental tax immunity is inherently linked to the notion of individual states as sovereign components of the federal system. Perhaps the most essential right of a sovereign state is the right to raise funds to finance its activities through such taxation and borrowing programs as it finds appropriate. While states are generally subject to nondiscriminatory taxes on various transactions in which they might engage, it clearly remains the law at this time that the core functions of states as states are beyond the reach of federal taxation.

This Court continues to recognize the reservation to the states of those powers not delegated to the federal government or otherwise prohibited to

the states. The extension of federal taxation to the borrowing powers of the states as attempted in TEFRA clearly intrudes on those reserved powers and justifies the intervention of this Court to declare such an attempt unconstitutional.

ARGUMENT

- I. SECTION 310(b)(1) OF TEFRA IS AN UNCONSTITUTIONAL INFRINGEMENT ON STATE SOVEREIGNTY AS MANIFESTED IN THIS COURT'S DECISIONS ON INTERGOVERNMENTAL TAX IMMUNITY.

The legislation at issue in this case is §310(b)(1) of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Pub.L. 97-48, 96 Stat. 596, codified as §103(j) of the Internal Revenue Code, 26 U.S.C. §103(j) (1982 ed.). It requires that municipal bonds,¹ in order to retain their former exemption from federal income

¹The Special Master has discussed the details and mechanics of the municipal borrowing process and markets in Part IV of his Report (at 19-33). It is sufficient for present purposes to note that municipal bonds are debt instruments issued by states or their political subdivisions, the great majority of which constitute "registration required obligations" as described in TEFRA §310(b)(1).

taxation of their interest, must be in registered form if issued after June 30, 1983, the effective date of TEFRA.

Before this date, almost all municipal bonds were issued in bearer form. Bearer bonds are negotiated by transfer and are presumed to be owned by those who hold them. Holders of bearer bonds detach coupons which are presented for the payment of interest. The ownership of registered bonds, on the other hand, is recorded on one or more lists and interest payments are made by check or electronic transfer. Because bond investors demand a higher yield on a taxable debt obligation, TEFRA's mandated loss of tax exemption for bearer instruments is such that no state or local government has issued bearer bonds since the enactment of TEFRA.

This court has long held the traditional view that municipal bonds are immune from federal taxation. Pollock v. Farmers Loan & Trust Co., 157 U.S. 429 (1895). Such immunity is rooted not in legislative grace, but rather grows from the very soil of state sovereignty under the Constitution. In considering whether income from municipal bonds could be subjected to a federal corporate net income tax, this Court held that such an application of the tax in question would cause it to fall directly upon the power of a state to borrow money, an incident the federal government lacked the constitutional authority to tax, and was thus constitutionally impermissible. Pollock at 586.

There is no disagreement with the Special Master's characterization of Pollock as a case which imposes an absolute prohibition on the federal taxation of municipal bond interest, without regard to the magnitude of the burdens such taxation might impose on the states. Masters Report, at 160. Nor is it argued that later cases have not taken a more flexible view of this immunity and limited its application in certain circumstances. It is clearly not the case, however, that there has been any substantial limitation of a constitutionally based intergovernmental immunity from taxation of certain activities and prerogatives which are at the very core of state sovereignty, such as the ability to fund its own operations through taxation and borrowing.

This link between the tax immunity of the states and state sovereignty survived the passage of the Sixteenth Amendment in 1913. In Metcalf & Eddy v. Mitchell, 269 U.S. 514 (1926), the Court, citing Pollock and Weston v. City Council of Charleston, 27 U.S. (2 Pet.) 449 (1829), reiterated the link between intergovernmental tax immunity and sovereignty:

This Court has repeatedly held that those agencies through which either government immediately and directly exercises its sovereign powers, are immune from the taxing power of the other. Thus, its obligations sold to raise public funds, its investments of public funds in the securities of private corporations, for public purposes surety bonds exacted by it in the exercise of its police power are all so intimately connected with the necessary functions of government, as to fall within the established exemption; and when the instrumentality is of that character, the immunity extends not only to the instrumentality itself but to income derived from it.

269 U.S. at 521 (citations omitted).

While the scope of state income tax immunity has diminished in the years since Metcalf, the immunity itself, and its central concept, survive.

The Special Master has concluded that Metcalf & Eddy and its progeny (Helvering v. Mountain Producers Corp., 303 U.S. 376 (1938); Helvering v. Gerhardt, 304 U.S. 405 (1938); Graves v. New York ex. rel. O'Keefe, 306 U.S. 466 (1939)) stand for the proposition that a federal tax could be imposed upon income derived from dealings with states unless there was a showing that such a tax would impair the states in their central functions. There is a common thread in these and other cases discussed by the Special Master in his Report (at 164-174), and it is on this basis that these cases are distinguishable from the case presently before the Court. None

of the cases discussed in the Report involve the basic fiscal and revenue powers of the state. Rather, these cases all involve the state as an economic competitor in the arena of commerce: as a contractor, James v. Dravo Contracting Co., 302 U.S. 134 (1937); as a lessor, Mountain Producers Corp., 303 U.S. 376 (1938); or as an employer, Gerhardt, 304 U.S. 405 (1938); and Graves, 306 U.S. 466 (1939)). There is no question that a state may be subjected to a nondiscriminatory tax which treats all such commercial actors equally. New York v. United States, 326 U.S. 572 (1946). Even the cases which involve municipal bonds can be distinguished; in both cases, the bonds themselves were merely transferred between private parties. Willcuts v. Bunn, 282 U.S. 216 (1931) involved a tax

on the capital gain when bonds are sold, and Greener v. Lewellyn, 258 U.S. 384 (1922) involved an inheritance tax upon the transfer of bonds at the holders death. The state was not a party to the transaction subjected to tax in either instance.

This distinction is brought into clear focus in Massachusetts v. United States, 435 U.S. 444 (1977), in which this Court found a federal excise tax upon aircraft constitutionally valid when applied to state aircraft. In this case, the state was acting not as a state, but as the owner and operator of aircraft, and was held liable for payment of a non-discriminatory²

²This Court has consistently recognized the constitutional validity of various flat taxes and user fees.

(FOOTNOTE CONTINUED ON NEXT PAGE)

user fee for the provision of airport facilities. Even in so holding, however, the Court continued to recognize the conceptual link between state sovereignty and intergovernmental tax immunity, stating that "the existence of the states implies some restriction on the national taxing power," 435 U.S. at 454. Neither Massachusetts nor any of the earlier cases relied on by the Special Master

(FOOTNOTE CONTINUED)

Capitol Greyhound Lines v. Brice, 339 U.S. 542 (1950). Massachusetts v. United States represents the extension of this type of tax to the states when they enjoy, on the same basis as private users, the use of the facilities funded by the tax. While Massachusetts involved a federal "user fee" imposed on all civil aircraft, including those used by the states for law enforcement, in order to recoup costs for federal aviation programs, the Court did not find the distinction between a tax and a user fee significant for purposes of analyzing immunity, at 435 U.S. 460, n.18.

sanctions a tax which falls directly on the core activities of states as states. Thus, while any number of state functions are subject to taxation,³ the central concept of the traditional view -- the link between sovereignty and immunity -- is preserved in the Court's continued recognition that "the limitation [on state sovereignty] cannot be so varied or extended as seriously to impair . . . the appropriate exercise of the functions of the government affected

³See, e.g., New York v. United States, 326 U.S. 572 (1946) (tax on water bottled and sold by State upheld); Helvering v. Gerhardt, 304 U.S. 405 (1938) (federal tax on salaries of state employees upheld); Allen v. Regents, 304 U.S. 439 (1938) (Tax on admissions to state athletic events upheld even though funds were used to support essential state functions); Helvering v. Powers, 293 U.S. 214 (1934) (tax on operations of railroad by State); Ohio v. Helvering, 292 U.S. 360 (1934) (tax on state liquor operation).

by it." Massachusetts v. United States
(quoting New York v. United States), 435
U.S. at 459.

Massachusetts analyzes the
limitation on Congress' taxing power in
terms of a balancing of the benefits and
burdens created by the legislation.
This analysis takes as its premise not
the presumed rationality of the
legislation, but rather the irreducible
sovereignty of the states which federal
taxing legislation may not diminish.

Given that premise -- a premise
founded on the role of the states in the
federal system -- federal tax legis-
lation which impairs this sovereignty is
an improper exercise of Congress' taxing
power. This is the case with TEFRA.

While the traditional view of state immunity from taxation has been modified over time, the essential link between tax immunity and state sovereignty is still recognized by this Court. The cases holding that municipal debt is not taxable retain their vitality under the test set out in Massachusetts v. United States. The soundness of the traditional view is reinforced by the practical impact of TEFRA, which, by effectively depriving the states and municipalities of a principal means of raising tax-exempt revenue, represents an extension of the taxing power of the federal government which unduly interferes with the exercise of the states' functions. Massachusetts, at 466-467. Therefore, Section 310(b)(1) of TEFRA is an unconstitutional infringement on state sovereignty as exemplified in the states' tax immunity.

II. SECTION 310(b)(1) OF TEFRA IS AN UNCONSTITUTIONAL INFRINGEMENT OF STATE SOVEREIGNTY PROTECTED BY THE TENTH AMENDMENT TO THE UNITED STATES CONSTITUTION.

The Tenth Amendment to the United States Constitution provides:

The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people.

This Court has struggled in recent years to formulate a test or a method of analysis under which the judicial process can rationally and consistently discern the limits of state sovereignty under this provision. This Court has recently changed its view of this problem, turning away from a search for traditional governmental functions to look instead for those "postulates which limit and control" federal intrusion upon the retained sovereignty of the

states. Garcia v. San Antonio Metropolitan Transit Authority, 469 U.S. 528, 547 (1985) Garcia expressly overruled National Leagues of Cities v. Usery, 426 U.S. 833 (1976), which relied on the distinction between traditional and non-traditional governmental functions in holding that Congress could not, under its Commerce Clause power, enforce the minimum wage and overtime provisions of the Fair Labor Standards Act against the states.

In thus changing its viewpoint, however, this Court has not abandoned its recognition of the sovereign rights of the states, which they retain ". . . to the extent that the Constitution has not divested them of their original powers and transferred those powers to the Federal Government." Garcia, 469 U.S. 549.

Thus, the structure of the federal system itself plainly contemplates sovereign states with powers reserved to them. However difficult it may be to state an organizing principle in light of which those reserved powers can be clearly discerned, one proposition should be a beacon: sovereignty is meaningless in the absence of the right of a state to raise funds through such taxation and borrowing as it deems appropriate.

While the applicability of the Garcia decision to this case can be effectively questioned on the narrow ground that it expressly limits itself to Commerce Clause enactments,⁴ there

⁴Unlike the legislation challenged in Garcia, TEFRA 301(b)(1), affects only states and municipalities. The Fair

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is a broader argument in support of judicial review. The fundamental reason for this Court's holding in Garcia was judicial deference toward a question which was not susceptible to meaningful resolution within the judicial process. The Court was properly concerned that an "unelected" judiciary would interpose itself in decision making which was

(FOOTNOTE CONTINUED)

Labor Standards Act challenged in Garcia applied to all employees, both public and private. State and local governments unsuccessfully challenged this application on Tenth Amendment grounds. TEFRA, however, affects only the states. It eliminates an entire category of tax-exempt debt formerly available only to states. TEFRA, therefore, is not a Commerce Clause based enactment, applicable by its terms to the whole nation, from which the states seek an exemption. It is tax legislation which impairs the function of the states as states, not as operators of a particular enterprise or providers of a particular service.

essentially political (i.e., legislative) in nature.

The present case presents no such dilemma. No bright line need be drawn to reach the conclusion that the state's fundamental revenue processes are beyond the constitutional reach of federal legislation. The fact that state delegates to the federal legislature participated in the decision process does not bear upon the constitutionality of the legislation which resulted in this case. Pollock v. Farmers Loan & Trust Co., 157 U.S. 429 (1895) remains the law with respect to the constitutional inability of federal taxation to reach state municipal bonds. Garcia's reservation of judicial review should properly be called upon in this case to invalidate TEFRA 301(b)(1).

The raising of revenue is not merely a function which states are reluctant to abandon because they have traditionally enjoyed its exercise. The ability to effectively and efficiently raise revenues to provide essential public services, particularly at a time when federal budget constraints dictate an even larger role for the states, is of crucial importance to the states' continued ability to perform their roles as sovereign entities in the federal system.

The ability to decide how revenue is to be raised and spent is an inherent aspect of sovereignty. Sovereign governments must be free to determine how revenue is raised and how it is appropriated if their ability to govern and provide needed services is not to be impaired. Legislation which effectively

restricts the choices of revenue producing activity available to the states violates a "postulate which limits and controls" Congressional action, the postulate of fiscal self-determination.

The structure of the federal system plainly contemplates sovereign states with powers reserved to them. This reservation of power is meaningless if states cannot make the necessary decisions, or cannot raise the funds, to exercise these powers. No sweeping reading of the Tenth Amendment is required to hold that the notion of sovereignty is hollow if the sovereign cannot determine its own fiscal affairs. TEFRA 310(b)(1) impermissibly infringes on that power. Amici respectfully submit that it unconstitutionally

impairs the sovereignty of the states by restricting the states' ability to carry out their functions in the federal system. This Court should declare it unconstitutional.

CONCLUSION

For the foregoing reasons, amici urge this Court to find in favor of plaintiffs and respectfully urge the Court to find that TEFRA 301(b)(1) in imposing a tax on the interest of state and municipal bonds if not issued in registered form, is unconstitutional.

Respectfully submitted,

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